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In The

SUPREME COURT OF THE UNITED STATES

October Term, 1962

No. 838

CHARTER WIRE, INC.,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR PETITIONER

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HAMMERSMITH-KORTMEYER CO., MILWAUKEE

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In *John Kelley Co. vs. Commissioner,* 326 U.S. 521, cited by respondent, this Court stated, page 523, that the obligations in the *Kelley Co.* case and the *Talbot Mills* case had "one striking difference, the non-cumulative in one and the cumulative quality in the other of the payments received under the characterization of interest". In its decision affirming the Tax Court and reversing the Court of Appeals, this Court, page 526, followed *Dobson vs. Commissioner,* 320 U.S. 48, holding that it was the intention of Congress in enacting "Internal Revenue Code, Par. 1141 (c) POWERS (1)" to leave to the final de-

*Supplement C page 29 of the Petition refers to the 1939 Internal Revenue Code.

termination of the Tax Court all issues which were not clear-cut questions of law. Sec. 7482 (a) of the 1954 Internal Revenue Code disregards the rule of the *Dobson* case.

The decision of this Court in the *Kelley Co.* case therefore does not apply to the present case. A review by this Court of the conflicting decisions to resolve conflicts in the decisions in the various circuits and between the various circuits would appear desirable.

In *Jennings vs. United States*, 272 F. 2d 842 (See also *Jennings vs. United States*, 58-2 USTC Par. 9842, page 69455 which indicates exact proportions of stock ownership and loans), and the present case, the Court of Appeals for the Seventh Circuit reached opposite results on particularly identical facts.

In *Gloucester Ice & Cold Storage Co. vs. C. I. R.*, 298 F. 2d 183, 185, the Court of Appeals for the First Circuit by adopting the dissenting opinion in *Talbot Mills vs. Commissioner* (CCA 1) 146 F. 2d 809, 812, indicated that opposite results had been reached in the First Circuit in the forgoing two cases on similar facts. The decision in *Talbot v. Commissioner, supra*, overruled in the *Gloucester* case, was affirmed by this court in the *Kelley* case (326 U.S. 521).

The facts supporting petitioner's contention in the present case that the notes were debt obligations are much stronger than those upon which this Court held in *Kelley Co. vs. Commissioner*, 326 U.S. 521, supported petitioner's contention that the *Kelley Co.* debentures were debt obligations.

The following appear as the facts in *John Kelley Co. vs. Commissioner*, 326 U.S. 521 and *Commissioner vs.*

John Kelley Co. (CCA 7) 146 F. 2d 446: (1) the common stock was owned in the same proportion by the same stockholders before and after reorganization; (2) the debentures were subordinated to the claims of all other creditors; (3) payment of interest on the debentures was conditioned upon the sufficiency of net income to meet the obligation and defaulted payments did not accumulate; and (4) in the capital stock returns, the debentures were listed as capital stock and were not reflected as a liability in balance sheets appearing on the income and excess profit tax returns, but appeared under the heading "Capital Stock: Debenture Notes".

The Trial Court and Court of Appeals in the present case stress the fact that petitioner did not act as a creditor so as to hurt his position as a shareholder. The simplest case of pro rata is that of a debt held by a sole shareholder. It is difficult to conceive of circumstances where a single stockholder would act as a creditor so as to hurt his position as a shareholder. (16 Tax Law Review, Page 7)

The decision of the Court of Appeals in the present case is therefore in direct conflict with all cases such as:

Kraft Foods Company vs. Commissioner, (CCA 2) 232 F. 2nd 118.

Byerlite Corporation vs. Williams, (CCA 6) 286 F. 2d 285.

Gloucester Ice & Cold Storage Co. vs. C.I.R. (CCA 1), 208 F. 2d 183.

At present, the criteria to determine when an instrument is a debt obligation or capital contribution is determined by the Courts in all the cases cited in petitioner's and respondent's briefs. The argument of petitioner,

therefore, that these criteria be uniform in the various circuits and, even more important in each circuit, should be addressed to this Court. The need for this Court to establish more certain criteria for taxpayers to follow is demonstrated by the appeals that have been made to Congress by important Bar groups.

All the acts upon which the Trial Court and the Court of Appeals base their decisions that the notes in the present case were capital contributions, were normal acts by petitioner that occur in the management of corporate business. The occurrence of those acts should not be permitted to overcome the clear intent of the petitioner, as disclosed by the form and substance of the transaction that it intended the notes to be debt obligations.

The instruments were called notes and by their terms imposed an unqualified obligation to pay interest on fixed dates at a fixed rate; they imposed an unqualified obligation to pay a fixed principal on a date certain; and they conferred on their holders no voting rights or voice in the management of the obligor under any circumstances. (A. 97-103, 111-2). The noteholders had the right to enforce payment of interest and principal against any assets of the corporation. The notes were assignable without any transfer of stock.

The notes were carried on the books of the petitioner as debt obligations (A. 17) and no payment of interest was ever missed. (A. 17, 11). There is oral testimony that it was intended that the notes be paid. (A. 49, 54).

By making the notes payable at the death of the obligee, enforcement was taken out of the hands of the stockholder noteholder and given to the representative of his estate. (A. 97-103).

The fact that in the event A. W. Mellowes exercised an option to buy the stock of another stockholder, he had the privilege of applying against the purchase price notes or debentures of petitioner at face value, indicates that the instruments were intended as debt obligations. (A. 117-8, 120). From the facts that C. N. Mellowes gave his note to his wife in 1946 (A. 114), and that A. W. Mellowes, by his Will in 1948, placed in trust for his wife the note issued to him (A.127), it can only be inferred that it was the intention that the notes be paid. This inference is strongly supported in the Trial Court's findings and the testimony that both C. N. Mellowes and A. W. Mellowes at the time of incorporation of the petitioner insisted that the petitioner issue notes in part payment of the $240,000 net worth of the partnership as a safer investment than stock for their dependents in the case of their debts. (A. 23, 48-9, 156-7).

The partnership, at the time its assets were transferred to the petitioner, had a market value and net worth of $240,000 and earnings which during the last five years of its existence averaged $62,476.29. (A. 17). During the eleven years of its existence, the partnership prospered. (A. 8). The petitioner, at the time of its incorporation, had $680.00 in cash contributed by its stockholders (A. 17) and $240,000 of assets acquired from the partnership. (A. 17). It issued $66,805.74 of notes to the partnership in part payment of the partnership assets. (A. 7). Its ratio of equity capital to debt ($174,874.26 to $66,805.74) was more than adequate.

With earnings after taxes of $216,764.17 in 1955 and a net worth of $533,495.70 on December 31, 1955 (A. 113) and no bank loans from September, 1954 to March, 1956 (A. 12), there is no question that the petitioner could

have paid the notes at maturity if they had not been paid and cancelled in 1954 and new notes dated April 1, 1954 and maturing January 31, 1960 had been issued. (A. 14, 111-13).

Petitioner's net earnings after taxes in each of the three years, 1956 to 1958, were in excess of $115,000 and its net worth as per books on December 31, 1958, was $893,805.63. (A. 113). There could be no question as to the ability of the petitioner to pay the new notes on January 31, 1960. No weight was given by the Trial Court and the Court of Appeals in their decisions to the foregoing facts.

Respectfully submitted,

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